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CHERYL D. EDWARDS Petitioner, v. DISTRICT OF COLUMBIA OFFICE OF TAX AND REVENUE Respondent	Case No.: TR-C-09-800144

FINAL ORDER

I. Introduction

On July 23, 2009, Cheryl D. Edwards filed a Tax Protest with the Office of Administrative Hearings ("OAH") requesting a hearing to review an adverse decision of the Office of Tax Revenue ("OTR" or the "Government") regarding a Notice of Proposed Assessment of Tax Deficiency dated March 12, 2009 (the "Notice"), that assessed an income tax deficiency of $10,179, plus interest and penalties, for the 2007 tax year.[1]

I scheduled an evidentiary hearing on May 18, 2010, to consider Petitioner's tax protest. At the hearing, Edward A. Blick, Esquire, and Rosalie Maglione Alligood, Esquire, appeared on behalf of the Government along with the Government's witnesses, Nichole Wormsley, an OTR

[1] By Order dated March 24, 2010, I found that OTR mis-delivered the Notice of Deficiency and that Petitioner did not receive it until the first week in July 2009. Her tax protest, filed July 23, 2009, was therefore deemed timely.

Supervisory Tax Auditor and Robert McNair, an OTR Tax Technician. Petitioner appeared and testified on her own behalf and her accountant, Herman Marrell Foushee also testified. I admitted as evidence Petitioner's Exhibit ("PX") 101 (a copy of a check) and Respondent's Exhibit ("RX") 201 (a partnership schedule K-1).

At the commencement of the hearing, Mr. Blick indicated that the Government had revised its deficiency assessment based upon its decision to disallow only two of the total deductions Petitioner had taken in calculating her 2007 income tax – a partnership loss and an attorney fee payment. As a result, the Government had determined that Respondent' tax deficiency for 2007, before interest and taxes, was $6,394 rather than $10,179 as stated in the Notice. The hearing proceeded on the issue of whether Petitioner was entitled to deduct the partnership loss and the attorney fees and on the issue of whether OTR had notified Petitioner that it had disallowed these deductions.

Based upon the testimony of the witnesses, my evaluation of their credibility, the exhibits admitted into evidence, and the entire record in this case, I make the following Findings of Fact and Conclusions of Law.

II. Findings of Fact

On or about March 12, 2009, OTR issued the Notice to Petitioner, assessing a $10,179 income tax deficiency for the 2007 tax year. In March 2009, Mr. Foushee, Petitioner's accountant and preparer of her tax return, received both the Notice and a spreadsheet reflecting that the deficiency assessment resulted from OTR's disallowance of certain of Petitioner's deductions. After Mr. Foushee received the Notice, Petitioner provided OTR with a power of attorney authorizing him to represent her in connection with the proposed assessment.

The deductions that OTR had disallowed, as reflected in the spreadsheet, included a $78,900 partnership loss and $8,114 in attorney fees. The attorney fee deduction represented a portion of a $10,000 total amount Petitioner paid to an attorney to represent her in applying for licensure with the New York State Bar. At the hearing, the Government stipulated that only these two deductions remained at issue.

A. The Attorney Fee

Petitioner worked during part of the 2007 tax year for George Washington University as a lead research scientist in its Public Health Policy and Law Department. In addition to her research duties, the University required Petitioner to teach certain classes. Because she had been disbarred as a lawyer in New York, the University asked Petitioner to "correct" this situation and seek reinstatement to the New York Bar. By check dated November 26, 2007, Petitioner paid $10,000 to an attorney to represent her on her reinstatement application. PX 101. Of this payment, Petitioner deducted $8,114 in calculating her 2007 taxable income.

B. The Partnership Loss

Petitioner also deducted $78,900 as a partnership loss in calculating her 2007 taxable income. The Schedule K-1 she filed to document this loss reflects that she was a limited partner and owned a 50% interest in a partnership, Chermarr, and that her share of the 2007 "net rental real estate income (loss)" was $78,900. RX 201. Petitioner testified that her Schedule K-1 was inaccurate and that the

partnership did not engage in rental activity but rather renovated real estate for the purpose of resale. She maintained that the partnership loss therefore resulted from improvements to real estate.[2]

III. Conclusions of Law

In computing an individual's income tax, the District of Columba allows deductions from gross income that are generally the same as those allowed by the U.S. Internal Revenue Service 1986 Tax Code (the "IRC"). Chapter 18 of the D.C. Code describes these deductions as follows:

> In the case of an individual, estate, or trust, deductions allowed under this section shall be the same (and to the same extent) as the deductions allowed by the Internal Revenue Code of 1986 on federal individual or fiduciary income tax returns.

D.C. Official Code § 47-1803.03(b)

Absent D.C. Court of Appeals precedent, in addressing the issues in this case, I have relied upon the IRC, federal regulations, and cases interpreting these provisions.

A. Burden of Proof

The Supreme Court has differentiated challenges to income tax deductions from other tax disputes, which are generally "construed against the state and in favor of the taxpayer," and has held that deductions are a "matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 592 (U.S. 1943); *See School St. Assoc. Ltd. P'ship v. District of Columbia*, 764 A.2d 798, 805 (D.C. 2001).

[2] Because I have concluded that Petitioner is not entitled to deduct partnership losses emanating from either real estate rental activity or renovations, I need not resolve the conflict between Petitioner's testimony and the Schedule K-1 that she submitted to support this deduction. *See* Section III(B) *infra*.

When a taxpayer challenges the Government's assessment of an income tax deficiency, the burden falls on the taxpayer to maintain sufficient records to substantiate claimed deductions. In *Doudney v Comm'r*, T.C. Memo 2005-267, 2005 Tax Ct. Memo LEXIS 269 *11-12, the court held that:

> A taxpayer must keep records adequate to allow the Commissioner to establish the amount of his deductions . . . A taxpayer must also produce those records upon request for inspection by authorized [tax authorities]. We are not required to accept an interested party's self-serving testimony that is uncorroborated by persuasive evidence.

Even though the Government may not indicate the theory upon which it intends to defend its position in disallowing deductions, it is sufficient to give the taxpayer notice of the deficiency and the basis for it. *Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359, 361-2 (9th Cir. 1974). Additionally, unless otherwise provided by statute, tax deficiency determinations premised on disallowed deductions are presumed to be correct and the taxpayer has the burden of going forward with the evidence to show that the determination is incorrect. *Barnes v. Commissioner*, 408 F.2d 65, 68-69 (7th Cir. 1969) *cert. denied*, 396 U.S. 836 (1969); *Underwood v. Commissioner*, 56 F.2d 67, 72-73 (4th Cir. 1932). If the taxpayer does not present evidence sufficient to prove an entitlement to the deduction, the notice of deficiency will be sustained, despite the Government's failure to present evidence supporting the deficiency. *See United Aniline Co. v. Commissioner*, 316 F.2d 701, 704 (1st Cir. 1963).

The Notice of Proposed Assessment of Tax Deficiency in this case notified Petitioner of a $10,179 assessed income tax deficiency for the 2007 tax year. Mr. Foushee, who prepared Petitioner's return and represented her under a power of attorney, received both the Notice and a spreadsheet reflecting that the deficiency assessment resulted from OTR's disallowance of certain of Respondent's deductions, including a $78,900 partnership loss and $8,114 paid as attorney fees in connection with Petitioner's application to the New York Bar. The Notice of Deficiency was "sufficient to raise the

presumption of correctness and to place the burden of proof" on the Petitioner. *Barnes*, 408 F.2d 65, at 68.

B. Attorney Fees

Generally, expenses paid or incurred for producing income are allowable as deductions. *See* IRC § 212. However, expenses incurred while securing the right to practice in a new trade or business are not allowable as deductions pursuant to 26 CFR 1.212-1(f) which disallows:

> Bar examination fees and other expenses paid or incurred in securing admission to the bar, and corresponding fees and expenses paid or incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions.

Costs associated with securing the right to practice law in another state constitute expenses incurred to practice a new trade or business and are unallowable deductions. *See Levine v. Commissioner*, T.C. Memo 1987-413 (T.C. 1987). Specifically, attorney's fees, paid to secure the right to practice law are not allowable. *Ryman v. Commissioner*, 51 T.C. 799 (T.C. 1969).

Similarly to this case, in *Kaufman v. United States*, 233 F. Supp. 123 (E.D. Pa. 1964), an attorney claimed deductions for legal expenses paid in the process of procuring reinstatement to the bar. The government argued that the legal fees related to the petitioner's efforts to become a licensed attorney and not his past business of practicing law, which had been terminated by disbarment. The court held that the petitioner's expenses related to his anticipated future business of practicing law and was therefore not deductible. *Id.* at 126. Similarly, securing the right to practice law in additional states constitutes a new trade or business and costs incurred to obtain this right are unallowable deductions. *See Levine v. Commissioner*, T.C. Memo 1987-413 (T.C. 1987).

Petitioner contends that she was seeking reinstatement to the New York State Bar at the request of her employer and not to practice law; however, this fact does not change the result. Even if Petitioner's employer had required her to obtain reinstatement as a condition of employment, these expenses are not deductible as they qualify her for a new trade or business. *Wright v. Commissioner*, T.C. Memo 1973-8 (T.C. 1973) (holding that teacher, who took law courses allegedly for purpose of meeting express requirements of his employer, cannot deduct costs of such education since they lead to qualifying him for a new trade).

Accordingly, OTR properly disallowed the $8,114 Petitioner deducted as a portion of amounts that she paid to an attorney to represent her in applying for reinstatement to the New York Bar.

C. Partnership Loss

The Internal Revenue Code places stringent limitations on deducting partnership losses incurred from real estate activities. Applicable to this case is the Code's "passive" designation for real estate rental activities. IRC § 469(c)(2). Passive losses may be only applied to offset passive income. IRC § 469(a)(1)(A). If Petitioner held an interest in a partnership engaged in renting real estate, as reflected in her 2007 Schedule K-1, she may only offset losses the partnership generated against passive income.

An exception to this rule is that individuals actively participating in a passive activity may offset up to $25,000 of losses derived from passive real estate rental activity against ordinary income. IRC § 469(i)(1). However, the taxpayer's adjusted gross income ('AGI") cannot exceed $100,000. Otherwise, the $25,000 allowance is phased out at a rate of 50 percent of the excess of AGI over $100,000.[3]

[3] IRC § 469(i) provides in part:

$ 25,000 offset for rental real estate activities.

Therefore, a taxpayer with an AGI of $150,000 or more gets no deduction. IRC § 469(i)(3); *Paleveda v Commr*, TC Memo 1997-416; 74 T.C.M. (CCH) 610 (1997).

In the instant case, Petitioner provided no testimony or records indicating the amount of her AGI for the 2007 tax year. Thus, if the Schedule K-1's characterization of the income as "net rental real estate income" controls in this case, Petitioner did not carry her burden to establish that her AGI was less than $150,000 and that she was thus entitled to deduct any of the passive loss allowance.

As noted previously, Petitioner testified that the Partnership's principal business activity was not renting real estate but rather the purchase, renovation and resale of property. Under IRC § 263(a) and 26 CFR 1.263(a)-1, real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers must be capitalized. *Carpenter v. Commr*, Memo 1994-289; 1994 Tax Ct. Memo LEXIS 292; 67 T.C.M. (CCH) 3126 (1994) (taxpayers were subject to capitalization rules because they built homes for resale). For purposes of IRC § 263(a), "produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow." 26 CFR 1.263(a)-1(i). Accordingly, no deduction is allowed for constructing new buildings or for permanent improvements made to increase the value of any property or estate. *Parks v United States*, 434 F. Supp 206, (1977, ND Tex) (payments by partnership for construction of apartment house, bond

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> (1) In general. In the case of any natural person, subsection (a) shall not apply to that portion of the passive activity loss or the deduction equivalent … which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).
>
> (2) Dollar limitation. The aggregate amount to which paragraph (1) applies for any taxable year shall not exceed $25,000.
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> (3) Phase-out of exemption. (A) In general. In the case of any taxpayer, the $ 25,000 amount under paragraph (2) shall be reduced (but not below zero) by 50

premium reimbursements to general contractor, FHA inspection and examination fees for inspections during construction and for providing mortgage insurance on financing, and supervisory fee paid to general partner, were all capital expenditures). Indirect costs such as depreciation, taxes and interest must also be capitalized. 26 CFR 1.263(a)-1(e)(3)(ii).

While capital losses may be used with no limits to reduce capital gains, the amount by which ordinary income may be reduced by capital losses in any year is limited to $3,000. IRC § 1211(b). Petitioner did not present any evidence to establish that she deducted her alleged partnership capital loss from capital gains. As a result, even if Petitioner's Schedule K-1 is incorrect in characterizing the partnership's business as real estate rental activity, her deduction of the partnership capital loss from ordinary income would not be valid.

In summary, if the partnership engaged in real estate rental activity, Petitioner did not carry her burden to establish that she was entitled to deduct any portion of the maximum $25,000 passive loss allowance. On the other hand, if the partnership engaged in the improvement or development of real estate, the cost of renovations, including indirect costs, must be capitalized and could not be validly deducted from ordinary income. Petitioner failed to establish that she had capital gains income from which to deduct these losses. Accordingly, OTR appropriately disallowed the $78,900 partnership loss.

D. Remand To OTR

In this case, the Government revised its deficiency assessment based upon its decision to disallow only two of Petitioner's 2007 tax deductions. As a result, Government's counsel indicated at the commencement of the hearing that OTR had determined that Respondent's tax deficiency for 2007,

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percent of the amount by which the adjusted gross income of the taxpayer for the taxable year exceeds $ 100,000.

before interest and taxes, was $6,394 rather than $10,179, as stated in the Notice. Yet, the Government did not present any evidence to substantiate the new deficiency amount. Similarly, the Government did not establish the amount of interest and penalties that may be due as a result of this deficiency.

Although I have affirmed the Government's disallowance of Petitioner's partnership loss and attorney fee deductions, OTR must re-calculate Petitioner's tax debt for 2007 based upon this Order. Within 45 days from the date of this Order, OTR must issue a notice of proposed assessment, including the tax owed and any interest and/or penalties due. Petitioner shall have the right to file a timely protest of OTR's notice of proposed assessment and must specify in that protest the issues she seeks to challenge.

IV. ORDER

Accordingly, it is, this _____ day of _____, 2010:

ORDERED, that OTR's disallowance of Petitioner's deduction of attorney fees and partnership losses in calculating her 2007 income tax is **AFFIRMED;** and it is further

ORDERED, that this case is **REMANDED** to OTR for further proceedings in accordance with this Order.

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Louis J. Burnett
Administrative Law Judge